IN THE

Supreme Court of the United States

No. 71-1665

October Term, 1972

UNITED STATES OF AMERICA,
Petitioner,

v.

DOUGLAS B. CARTWRIGHT, as Executor of the Estate of Ethel B. Bennett.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR THE RESPONDENT

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VI.

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Questions Presented

The question as stated by the Petitioner (Br. p. 2) (whether the regulation is valid) is not the basic issue. The basic question is the "value" of the mutual fund shares owned by Ethel B. Bennett within the meaning of the word "value" in § 2031 of the Internal Revenue Code. The regulation is only the Commissioner's own opinion, understandably biased, of how "value" should be determined under that section. It does not preclude the Court from considering the real issues in dispute, which are:

1. Was the fair market value of the mutual funds owned by Ethel B. Bennett at the time of her death:

(a) The $124,399.87 the executor would have received for them if she had sold them on that date (*i.e.* the bid or redemption price) or

(b) The $133,325.14 the executor would have had to pay to purchase the same number of additional shares on that date (*i.e.* the replacement cost or asked price)?

2. Is the difference (the $8,925.27 that would have to be paid to the broker as a commission on the purchase of the additional shares) an asset of her estate subject to the estate tax?

Once these questions have been answered, the Court will be in a position to determine if the regulation is a fair and reasonable interpretation of the statute or an arbitrary and unreasonable one.

3. May the Commissioner, by regulation, create an irrebuttable and conclusive determination of the value of a mutual fund share, thereby depriving the taxpayer of due process guaranteed under the Fifth and Fourteenth Amendments to the Constitution of the United States?

Statement of Facts

History of the Mutual Fund Issue.

Many millions of mutual fund shares have been valued for estate tax purposes since the enactment of the Investment Companies Act of 1940.

The Commissioner has admitted that for upwards of 20 years, until 1961 or 1962, he accepted returns valuing them at the net asset value or bid price (R. 10).

Beginning in 1961 or 1962, the Treasury Department conceived the idea of increasing the revenue significantly by valuing mutual fund shares at the "asked" price, *i.e.* at

their retail price or replacement cost (the price the executor would have to pay to purchase as many additional shares as the estate already owned) (R. 10).

Hundreds and perhaps thousands of protests were registered in District and Regional Offices and some of them reached the litigation stage in both the Tax Court and as claims for refund in the District Courts where, by law, the Department of Justice represents the Treasury (R. 11).

Included were two estate tax audits in the Western District of New York. Addie G. Baldwin had died on April 2, 1960, and Ethel Louise Stern on February 22, 1961. Both executors paid the deficiency and sued for refund in the U. S. District Court for the Western District of New York at Buffalo (R. 11-12).

The Department of Justice disagreed with this new Treasury concept of valuation. On January 14, 1963, it instructed the Chief Counsel of the IRS to refund the excess tax to the Baldwin Estate and on May 28, 1963, it directed the IRS to refund the tax to the Stern Estate (R. 11-12, 15-18).

The disposition of these cases in this manner was not confined to the Western District of New York. In the Florida case of *Estate of Charles M. Wilder* (R. 12, 19) the Justice Department was more explicit, saying that it "receded" from the position taken by the Internal Revenue Service and accepted the valuation at the price at which the shares could have been sold on the valuation date (R. 19).

These administrative refunds were noted by the tax services, particularly Research Institute of America, as evidence of the disagreement between the Department of Justice and its client on this issue. It noted that the Department of Justice had conceded in litigation that the correct value was the bid price (R. I. A. Tax Coordinator, Vol. 6, Chapt. P-6202.10, p. 42,143).

The Commissioner was confronted with a dilemma. The Department of Justice would order refunds to all executors who brought suit in District Courts.

So, the Commissioner issued a regulation that effective on or after October 11, 1963, the fair market value was replacement cost. T. D. 6680, 1963-2 CB 417. No reason was offered.

Then, to clear the dockets of all cases in which an adverse decision on the issue of value would be an unfavorable precedent, the Commissioner, on February 24, 1964, announced that the IRS would refund all taxes collected on the load if the decedent died prior to October 11, 1963. Rev. Proc. 64-18, 1964-1 CB (Part I) 681 (R. 13). This enabled him to make the reasonableness of his regulation the prime issue in a Tax Court case involving persons dying after October 11, 1963.

The regulation raised a storm of protest from taxpayers throughout the country. Executors have been forced to pay the extra tax because no one in the IRS can waive the regulation. Many of them brought suit in District Courts. Many thousands more filed claims for refund. Many thousands more paid under protest.

The particular facts of this case.

At the time of her death on December 4, 1964, the decedent, Ethel B. Bennett, was the owner of these shares of open-end investment companies or mutual funds:

(a) 2,568.422 shares of Investors Mutual, Inc. in her individual name and 2,067.531 shares in her name as trustee for her daughter, Dorothy B. Cartwright.

(b) 2,269.376 shares of Investors Stock Fund Inc.

(c) 1,869.159 shares of Investors Selective Fund, Inc. (R. 22). As more fully explained hereafter, Mrs. Bennett acquired none of her shares by purchase at the public offering price.

The executor of her estate reported the value of these shares, for estate tax purposes, as their net asset value or "bid" (redemption) price of $124,399.87 and paid the estate tax computed on this basis (R. 22).

The Commissioner of Internal Revenue assessed a deficiency in estate tax based on his determination that these shares were includible in the gross estate at the price the executor would have had to pay to purchase as many additional shares as the estate already owned on the valuation date, *i.e.* the "asked" or public offering price, totalling $133,325.14. (R. 22-23).

The executor paid the deficiency with interest and filed timely a claim for a refund of federal estate tax and interest in the amount of $3,092.59 (23). The claim for refund having been denied, the executor brought suit in the United States District Court for the Western District of New York (R. 4). The District Court ruled that § 20.2031-8 (b) of the Treasury Regulations, upon which the Commissioner had based the deficiency, was unreasonable and entered judgment for the taxpayer. The government appealed this adverse judgment to the Second Circuit Court of Appeals where judgment for the taxpayers was affirmed.

Investors Stock Fund, Inc., Investors Mutual, Inc. and Investors Selective Fund, Inc. (hereinafter sometimes referred to as "the Investment Companies") are open-end investment companies registered with the Securities and Exchange Commission, are subject to the regulations of said Commission and are regulated by the Investment Company

Act of 1940, 15 USC § 80a-1, *et seq.* These funds were organized and managed by Investors Diversified Services, Inc., Minneapolis, Minnesota. Investors Diversified Services, Inc. is not an open-end investment company. It acts as underwriter in marketing or distributing the shares of the Investment Companies it has organized and acts as investment manager for them (R. 23).

Shares of these Investment Companies are distributed exclusively by Investors Diversified Services, Inc. (hereinafter referred to as "IDS") pursuant to distribution agreements with the Investment Companies (R. 25). IDS is required by § 22(d) of the Investment Companies Act of 1940, 15 USC § 80a-22, to sell the shares at the current public offering price described in the prospectus (in this instance, net asset value plus a maximum sales charge of 8% of the public offering price). (R. 25).

IDS receives, in full payment for its services as distributor of these shares, a distribution fee equal to the amount by which the public offering price exceeds net asset value. The remainder of the purchase price is the "net asset value" which is remitted to the Investment Company. From its fee, IDS pays commissions to its sales representatives and other expenses incident to or in connection with the distribution and sale of the shares (R. 25).

The public offering price is the "net asset value, ordinarily determined daily, plus a maximum sales charge of 8% of the public offering price" (Lesser commission percentages apply for quantity sales). This is generally described as the "asked" price in the financial pages (R. 24).

The "net asset value" is computed daily as of the close of trading on the New York Stock Exchange. The total

assets are valued and the total outstanding liabilities are subtracted. The resulting net worth is divided by the number of outstanding shares to determine the "net asset value" per share. This is generally described as the "bid" price in the financial pages(R. 24).

There are four ways by which a person may acquire shares of these Investment Companies, as follows:

(a) By an initial investment at the asked or public offering price (R. 26). Mrs. Bennett acquired none of her shares this way (R. 26-30).

(b) By directing the investment of dividends and capital gains distributions on shares already owned in additional shares (a person who is already a shareholder, by written authorization, may appoint IDS as his agent to reinvest his cash dividends and/or capital gains in additional shares of the respective investment company at the "net asset value" or "bid" price without any additional charge or sales commission) (R. 26). Mrs. Bennett acquired some of her shares this way.

(c) By exchanging one of these funds for shares of another of these funds (any shareholder has the right to transfer or exchange his shares in any one or more of the Investment Companies managed by IDS into or for shares of any of its other Investment Companies at "net asset value" or "bid" price without sales or service charge) (R. 26). Mrs. Bennett did not acquire any shares in this manner.

(d) By gift or inheritance. Mrs. Bennett inherited most of her shares from the estate of her husband, Arthur Y. Bennett, who died on October 1, 1962. They had been reported on his estate tax return at their "net asset value"

or "bid" price and this valuation was accepted by the Commissioner, after audit. The number of these shares doubled after his death as the result of a two for one stock split (R. 26-30).

The certificate of incorporation of each of these Investment Companies gives each registered shareholder the right to require it to redeem his shares at any time at their "net asset value" and without charge (R. 25-26). The election made by each of these Investment Companies in their certificates of incorporation to have redeemable shares was preliminary to registration with the Securities and Exchange Commission (R. 79).

Although there are no restrictions on the transferability of shares of these Investment Companies, the shareholders ordinarily dispose of them by requesting the company to redeem them (R. 25). The redemption price is their "net asset value" calculated as of the close of business on the day of receipt of the surrendered stock certificate or request to redeem by the shareholder. There is no charge for redemption (R. 26).

If a mutual fund company decides to market its own shares without a sales charge, i.e. if a "load" fund becomes a "no load" fund, the value of the shares is then publicly quoted at net asset value for the purpose of both sale and redemption (R. 60-61).

Summary of Argument

All that the Estate of Ethel Bennett could get for her mutual fund shares was $124,399.87. The Commissioner concedes this.

Nevertheless, the Commissioner valued them in her estate at $133,325.14. This was the public offering price on

the date of her death, i.e. the amount that only the issuing companies and their marketing agent could get for them on that date. The $8,925.27 difference would be the commissions paid to the marketing agent, i.e. the costs of acquiring new shares; not an element of value of the shares already owned.

The Commissioner relies on the power given to him by Congress to make such determinations, contending that Reg. Sec. 20.2031-8(b) valuing mutual fund shares at "replacement cost" is a reasonable interpretation of the word "value" as it is used in § 2031 and § 2033 of the Internal Revenue Code, i.e. that their value to the estate is properly measured by the price the executor would have to pay the Investment Companies and their marketing agent to acquire as many more shares.

The Commissioner attempts to justify his position by comparing mutual fund shares owned by a decedent with gifts of single premium life insurance policies on the life of another and gifts of diamond rings subject to wartime luxury excise taxes. The relationship is obscure but his reason is transparent. It provides at least a pretense that he was not totally unreasonable.

The true comparison is between a mutual fund share and a share of General Motors.

The price of a share of General Motors quoted in the papers does not include a purchasing commission. The Commissioner says the quoted price is its value.

The bid price of a mutual fund share quoted in the papers, likewise, does not include a purchasing commission. Contrarily, the Commissioner says the bid price is not its value.

The replacement cost of a share of General Motors is the price quoted in the papers plus a purchasing commission. The Commissioner says this is not its value.

The replacement cost of a mutual fund share is the bid price plus a load or purchasing commission (asked price). Contrarily, the Commissioner says this is its value.

After valuing mutual fund shares like shares of General Motors for 23 years after the Investment Companies Act of 1940, the Commissioner, in 1963, quite inconsistently decided that the value of a mutual fund share includes the purchasing commission.

The regulation arbitrarily ignores the best evidence of value which is the price for which the estate can sell the shares; the same test the Commissioner uses in the case of all other types of securities. If mutual fund shares were valued under the Commissioner's regulations for stocks and other securities, they would be valued at their net asset value. This interpretation, long continued without substantial change, should be deemed to have Congressional approval and the effect of law.

The Commissioner's attempt to value them since 1963 under the regulation for single premium life insurance policies on the life of another deserves no respect as a contemporaneous construction of the statute.

The regulation is out of harmony and inconsistent with the statute. Value, as the word is used in § 2031 and § 2033 of the Code, means what the property of the decedent is worth; not what a retail dealer can get from a member of the general public for the retail dealer's property, as the Commissioner contends in his brief.

The bid price and the asked price are not "reasonable alternatives" from which the Commissioner, in his discretion, can make a reasonable choice. One is right and the other is wrong. Is their value the $124,399.87 the estate could get for them? Yes. Is their value the $133,325.14 that only the Investment Companies and their marketing agent could get for them? No. The regulation is unreasonable.

The regulation purports to create a conclusive, irrebuttable presumption that value is "replacement cost" precluding consideration of any other relevant evidence or factors or elements of value. It purports to nullify any contrary evidence or contrary findings of a court of law. It deprives taxpayers of due process under the Fifth and Fourteenth Amendments.

ARGUMENT

POINT I

Applying the ordinary rules of valuation, mutual fund shares would be valued at their bid price or net asset value for estate tax purposes.

A. The price at which publicly traded shares are bought and sold is exactly the same as the prices at which mutual fund shares are bought and sold. In all cases the purchase price and the selling price is the same. The only difference is the way the price is quoted in the newspapers, the former being quoted without broker's commissions, whereas mutual fund shares are quoted inclusive of broker's commissions.

It is essential to a discussion of the issues that there be a thorough understanding of the basic sameness of the transactions in both publicly traded shares and mutual fund shares and the basic difference in the way they are quoted in the financial pages. It is best explained by an illustration.

Mr. B purchases a share of General Motors through Merrill Lynch for $100. Mr. S sells it to him through Merrill Lynch for $100. The purchase price and the selling price are both $100.

But Merrill Lynch, as the broker, is entitled to be paid for its services. Both Mr. B and Mr. S know this and agree to pay either a purchasing price or a selling commission. If Merrill Lynch charges both a 2% commission, Mr. B's total cost is $102 and Mr. S's net selling price is $98.

If the market quotations for the day included the purchasing commission and deducted the selling commission, the quotation would be $102-$98. But they do not.

The significant fact is that both the purchase price and the selling price are $100.00. This being the best evidence of the price at which the shares changed hands between Mr. B and Mr. S, the Commissioner agrees that $100.00 is the fair market value for estate tax purposes. Reg. Sec. 20.2031-2(b).

Applying the same analysis to mutual fund shares, we find that Investors Stock Fund, Inc. offers its shares to the public at their net asset value of $100. The offer is made through a distributor or marketing agent (Investors Diversified Services, Inc.) which, like Merrill Lynch, is entitled to be paid for its services as a broker. The terms of the offer are that the purchaser must pay the broker's commission (so that the fund, belonging to other shareholders, will not be diluted by selling costs). The purchaser pays $100 for the shares and, in addition, pays $8 to the broker. The selling price as far as the owner (Investors Stock Fund, Inc.) is concerned is $100. The cost to the purchaser is $108, but the cost, as far as he is concerned, is (1) $100 as the purchase price of the shares and (2) $8 for the broker.

The purchaser understands that if he later tenders his shares for redemption, his selling price to Investors Stock Fund, Inc. will be $100.00 and the redemption price to be paid by Investors Stock Fund, Inc. will be $100.00.

The only difference is that broker's commissions are not included in the quoted prices for General Motors; but are included in the quoted prices for mutual fund shares.

If mutual fund prices were quoted in the financial pages like the prices of listed stocks, the quotations would be as shown below:

Mutual Fund Prices

	Bid	Ask
Aberdeen Fnd	2.06	2.06**
Anchor Grwth	10.82	10.82*
Chase Fnd Bos	10.88	10.88*
Hartwell	13.78	13.78**
Investors Mut Fnd	10.22	10.22*
Investors Sel Fnd	9.62	9.62*
Investors St. Fnd	21.04	21.04*
Mass Inv Tr	12.42	12.42*
One William	17.89	17.89**
Putnam Grwth	12.13	12.13*
Wellington Exp	26.10	26.10*

The significant and basic fact is that Investors Diversified Services, Inc. is a marketing *agent* playing the same role played by Merrill Lynch in the sale of shares of General Motors. The 8% commission paid to it is the same, except as to percentage, as the commission paid to Merrill Lynch, Goodbody or any other broker. In one case the commission is separately stated on a confirmation slip. In the other it is included in the total.

If the fair market value of a mutual fund share is $108, the fair market value of the share of General Motors is $102. The Commissioner chooses to disagree, saying that the value of the General Motors share is $100, but that the value

*means plus commissions to be paid to the broker or distributor at the rate of 8% of the gross selling price, inclusive of the commission. Lower commission rates apply to purchases exceeding $15,000 $20,000.00, $25,000, etc.

**means "no load" funds, *i.e.* shares can be purchased direct from the fund without payment of commissions to a broker.

of the mutual fund share is $108. The Commissioner's inconsistency in valuing them differently is an incomprehensible, arbitrary and unreasonable distinction.

B. Mutual fund shares would be valued at the bid price if valued under the stock and bond regulations in Reg. Sec. 20.2031-2 (a)-(h).

The entire concept of valuation of securities for estate tax purposes, as it is set forth in the long-standing and Congressionally and judicially approved regulations of the Commissioner, is predicated on the determination of fair market value in terms of *selling* price, *i.e.*, what the estate can "get for" it Reg. Sec. 20.2031-2(a)-(h).

Subdivision (a) is introductory. Subdivision (b), (c) and (d) deal with the values of securities on national exchanges or traded in over-the-counter markets. The objective of the regulation is to get a reasonable approximation of the prices at which the estate might have sold the shares on a particular day when a listed stock like General Motors or an unlisted stock might have sold for 100⅝ in the morning and 99⅜ in the afternoon. Selling prices obtained from unofficial sources are to be substantiated by "evidences of sale". The entire phraseology of these subsections is in terms of the mean between the "highest and lowest quoted selling prices", "highest and lowest available sales prices", "based on selling prices", based on "incomplete selling prices", etc. Reg. Sec. 20.2031(b), (c) and (d).

Applying this rule to the shares in question, there is no uncertainty about the selling price available to the Estate of Ethel Bennett on the date of her death. The exact selling price is computed to the penny daily in accordance with strict SEC regulations and all such sales are made

at that price, whether the sale is by the Investment Company or by the owner. The value of few, if any, corporate securities is valued so precisely.

No adjustment is made or even permitted for the brokerage commission payable by the seller of a listed stock and the government freely admits that the broker's commission a purchaser would pay for such shares is not to be added to the selling price to determine value. Under these subsections, mutal fund shares would be valued at the bid price.

Subsection (e) entitled "Where *Selling* Prices or Bid and Asked Prices Do Not Reflect Fair Market Value" forcefully demonstrates that the probable selling price of the stock owned by the estate is the criterion to be used in estate tax cases and not what the executor would have to pay (including broker's commissions) for as many additional shares. It says in substance that if "*selling* prices or bid and asked prices do not correctly reflect the fair market value, then some reasonable modification of that basis or other relevant facts and elements of value are considered in determining the fair market value." This subsection then enunciates the "blockage" rule saying that "If the executor can show that the block of stock to be valued is so large in relation to the actual *sales* on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be *sold* as such outside the usual market, as through an underwriter, may be a more accurate indication of the value than market quotations." (Emphasis added.)

It is clear from the judicial development of the "blockage rule" that liquidation values and appraised selling prices are controlling in securites valuation in recognition of the

obvious economic fact that a sudden unloading of a large quantity of a commodity tends to drive the price down.

It is interesting to note that this rule was long opposed by Treasury. *Helvering v. Safe Deposit and Trust Company of Baltimore*, 95 F. 2d 806; *Helvering v. Kimberly*, 97 F. 2d 433; *Commissioner v. Shattuck*, 97 F. 2d 790; *Helvering v. Maytag*, 125 F. 2d 55, cert. den. 316 U. S. 689; *Jenkins v. Smith*, 21 F. Supp. 251. The Internal Revenue Service finally acquiesed and issued Reg. Sec. 20.2031-2(e) in conformity with these decisions. A regulation was needful. It defined value in terms of its *value* to the estate.

Subsection (f) provides guidelines for the valuation of the stock of closely held corporations for which there is no public market. This is the section the Commissioner uses to value the stock of a private investment company, using exactly the same criteria used in the determination of the net asset value of mutual fund shares.

The Commissioner has amplified his understanding of how to value the shares of a private investment company in Rev. Rul. 59-60, 1959-1 CB 237, at page 243, as follows.

> "(b) The value of the stock of a closely held investment or real estate holding company . . . is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company . . . The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the dates of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal. . ."

Clearly, mutual fund shares would be valued at the bid price if valued under Subsection (f) and the Commissioner's interpretation of it in valuing a private investment company. The ruling says it may be proper to discount the net asset value of a private investment company by the cost of liquidating it. It makes no sense that he should value a private investment company at a discount and a mutual fund company at a premium.

Subsection (g) is not relevant, but subsection (h) dealing with securities subject to an option or contract to purchase is very relevant indeed, because of the contractual obligations entered into between mutual fund shareholders and the investment companies. Their promise to redeem shares, made a part of their certificates of incorporation and renewed in the prospectus, becomes a matter of contract when accepted by the shareholder when he purchases shares. This is a bona fide arms-length business arrangement.

Subsection (h) was promulgated in recognition of the fact that stock subject to a redemption or option agreement cannot possibly be sold for more than the agreed price and that it would be illusory to consider its value to the estate to be anything but that price. Like (f) it is tailor-made" for valuing mutual fund shares.

In summary Reg. Sec. 20.2031-2, as presently written, contains theories of valuation of stocks and securities which antedate the 1939 Code, survived all the revisions of law made by the Internal Revenue Code of 1954 and still remains unchanged 17 years later. They were a contemporaneous construction or interpretation of the word "value" as it appears in § 2031 of the Code and, in general, must be presumed to fairly and reasonably reflect the intent of Congress that fair market value is to be determined in terms of what the estate can sell it for, *i. e.* its value to the estate.

C. Actual sales of mutual fund shares are the best evidence of their value.

Evidence of what the identical property sold for is universally considered competent, substantial and persuasive evidence of its fair market value on the material date. *Douglas Hotel Co. v. Commissioner,* 190 F. 2d 766 (8th Cir. 1951). It is the "very best of evidence" because it is directly reflective of market value. *Slater v. Commissioner,* 1959 TC Memo. 125; *Cf. Visile v. State,* 30 AD 2nd 1042 (4th Dept. 1968), aff'd 24 NY 2d 966 (1969).

The very best evidence of what owners were selling their shares for to the Investors Companies on the date of Mrs. Bennett's death was the redemption price quoted in the *Wall Street Journal* for that day. It was the only price any owner, living or deceased, could get for such shares on that date in the normal course of business. The government concedes this (Stip. 12-14, R. 25-26) and has made no effort to prove otherwise.

After her death some of her beneficiaries sold the mutual fund shares inherited from her at the bid price (Stip. 32 and 34, R. 31). These actual sales are also directly reflective of and the best evidence of fair market value.

In fact, it is matter of statutory law that all an owner gets for his mutual fund shares through redemption is their net asset value. Investment Companies Act, 15 USC, § 80a-2 (32).

It is also a matter of statutory law that the new investor must pay the commission of the marketing agent. Investment Companies Act, 15 U. S. C. Section 80-22(d). Therefore, the price others must pay to the investors companies and as commissions to their marketing agent for new shares is the worst possible evidence of what the estate could get for the shares it already owns.

That the actual sale price is the best evidence of value has recently been acknowledged by the Internal Revenue Service in Rev. Rul. 70-512, 1970-2 C. B. 192, where the Commissioner held that the actual selling price of stock sold during the one-year period following the date of decedent's death is the best evidence of value for estate tax purposes, making resort to the valuation formulas set out in the regulations neither necessary nor appropriate.

Reg. Sec. 20.2031-8(b) completely ignores the best evidence of value.

D. The net asset value (bid price) meets all the conditions of the willing buyer-willing seller test whether the sale is to a new investor at the asked price or back to the company at the bid price.

Reg. § 20.2031-1(b) provides that "the fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of relevant facts". The net asset value meets all the conditions of this formula; the asked price does not, as explained below:

Sales at the public offering price.

The willing seller of the shares purchased by a new investor is the open-end investment company. It sells at net asset value. The new investor is a willing purchaser at net asset value payable to the mutual fund plus a sales commission payable to IDS.[1]

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[1] George Hartley, Director of Funds Accounting and Service and Assistant Director of the six Investors Companies, testified that the mutual funds are the sellers; that at no time does IDS ever own the shares; that IDS is an agent performing a marketing function only; that the sales charge is paid to IDS and that no part of it goes to the mutual fund. R. 71-72, 74-75.

The Prospectus explains to the new investor that the mutual fund company is a willing seller at net asset value and that he is paying the commissions of its agent, as follows:

> "IDS receives, in full payment for its services as distributor of shares of Capital Stock of the Company, a fee equal to the difference between the amount received with each application and the asset value of the shares sold pursuant to such application, determined as stated in Section 15 which also gives the present rate of distribution fee." (Exh. 3, 4, 6, Section 16, page 14.)

The financial statement certified by Peat Marwick Mitchell & Co., confirms this in the "Notes to Financial Statements" saying:

> "Sales charges were not an expense of the Company. They are deducted from and are not included in the proceeds of sales of capital stock as shown in the accompanying statements of paid-in surplus. From such charges IDS pays commissions to saleman, salaries and other sale expenses." (Exh. 3, 4, 6. Financial Statements, page 26.)

This is substantial evidence that the net asset value is the price at which shares change hands between willing buyers and willing sellers.

Reinvestment of dividends in capital gains.

Owners of the investors companies shares are permitted, in fact encouraged, to reinvest their dividends in capital gains in additional shares at net asset value and without the payment of a sales charge (Exhibit 3, 4, 6). The fact that shareholders reinvested 31.13% of the cash distribution to which they were entitled in 1964 (R. 83) is substantial evidence that they were willing purchasers and that the investment companies were willing sellers at net asset value.

Exchange of shares of one of the investors companies for shares of another at net asset value.

Shareholders of Investors Stock Fund, Inc. are permitted to exchange their shares for shares of Investors Mutual, Inc. (for example) at net asset value and without sales charge. In 1964 these exchanges accounted for 11.69% of the sales of shares of these investment companies (R. 83). This too is substantial evidence of the price at which shares change hands between willing buyers and willing sellers.

Redemption at the bid price.

All sales by owners of mutual fund shares to and all purchases of mutual fund shares by the investor's companies (redemptions) are at net asset value. There is no intermediary or agent and no redemption charge, leaving as the only question whether both are willing buyers and willing sellers at the redemption price. The millions of shares that are tendered by shareholders and redeemed by investment companies each day at the bid price are irrefutable proof that the net asset value is the price at which shares change hands between willing buyers and willing sellers.

E. The net asset value has been recognized for over 20 years as the fair market value in the Investment Companies Act of 1940, by the Securities and Exchange Commission, the National Association of Underwriters and Securities Dealers, the mutual fund companies and the brokers and public generally.

Reg. Sec. 20.2031-1(b)—Valuation of Property in General—states that "All relevant facts and elements of value as of the applicable valuation date shall be considered in every case."

It is surely relevant that the net asset value is universally recognized (except by the Commissioner) as representing the value of a mutual fund share. Some of the relevant facts are:

1. Congress itself was explicit in its definition of the value of redeemable securities when it enacted the Investment Companies Act of 1940. A "redeemable security" is defined in the Investment Companies Act as any security "under the terms of which the holder . . . is entitled to receive approximately his proportionate share of the issuer's current net assets or the cash equivalent thereof." 15 USC, § 80a-2(32). The *value* of the net assets of the registered investment company from which the holder is entitled to receive his proportionate share is defined in § 80a-2(41) as being their current market value (of the underlying assets).

2. § 80a-22(d) prohibits the sale of any redeemable security except at "a current offering price described in the prospectus". The "current offering price" is the "net asset value" (which goes to the Investment Company) plus a sales commission (which goes to the marketing agent).

3. § 80-a2(35) defines the "sales load" as being "the difference between the price of a security to the public and that portion of the proceeds that is received and invested by the issuer." Nowhere in § 80a-2(35) or in any other section of the Investment Companies Act is the sales load identified with value or valuation. It is reflected in the public offering price, but the Investment Companies Act makes it clear that the sales load is available only to the agent, whether he be a broker, a dealer, a promoter or underwriter.

4. The entire theme of the prospectus issued by these Investors companies is based upon *value* in terms of net asset value. The shares are offered at net asset value. The shareholder is to receive the net asset value if he tenders his shares for redemption or the equivalent in net asset value if he exchanges the shares of one IDS affiliate for shares of another. Nowhere in the prospectus is there any suggestion that the sales charge is of any significance to the purchaser in terms of value. Item 17, entitled "Redemption of Shares", makes it abundantly clear that the *value* of the shares to anyone, alive or dead, will be the "asset value calculated as of the close of business on the day of receipt of the surrendered stock certificate or request." Exhs. 3, 4, 6.

The "Illustrations of Assumed Investment Programs" published in chart form in the prospectus specifically state, in accordance with SEC regulations, that the $10,000.00 initial investment has an initial asset value of $9,200.00 (R. 47). This is explained in a footnote as follows:

> "Initial net asset value is the amount received by the Fund after deducting from the cost of the investment the sales commission as described in the prospectus." (Exh. 3, 4, 6. Section 11, page 7).

5. § 80a-29 requires each investment company to file annual reports and render annual reports to the shareholders conforming to the rules of the SEC. Value is always expressed in terms of net asset value (R. 45-47).

The financial statements and computation of capital stock and surplus of these corporations are all computed in their annual reports in terms of the net value of the assets. Stockholders are told that "net asset value of your shares on October 31 of this year amounted to a record high of $21.12 compared with $18.83 per share at the close of

the preceding fiscal year." The sales charge is not an element of value on the books of the Investors' companies, because it is paid to Investors Diversified Services, Inc. and disappears in the form of commissions and selling expenses of the distributor. Exhs. 1, 2, 5; (R. 74-75).

6. The expert testimony of Fred Cohn explained the concept of valuation as it is used in the industry[2]. He testified that the public offering price or asked price is never used as the value of mutual funds in that industry (R. 48) and that the use of the net asset value as the criterion is in accordance with the official policy of the Securities and Exchange Commission and the National Association of Securities Dealers. (R. 45).

His firm has always valued mutual funds at the bid price, both for portfolio purposes and for estate tax purposes (R. 54-55) and, based on his more than 20 years of experience in the investment business and in preparing and compiling the data appearing in the "Johnson Charts", he does not agree that these shares should be valued at the asked price. (R. 55).

7. One of the most impressive of the relevant facts is that none of the many hundreds of Revenue Agents who audited estate tax returns between 1940 and 1961 saw fit to raise the issue on his own initiative.

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[2] Executive Vice President of Hugh Johnson & Co., Inc., a Buffalo brokerage firm with approximately 200 employees with membership on the New York Stock Exchange, doing about 30% of its gross business in the sale of mutual fund shares and the compiler and publisher of the "Johnson Charts", an annual publication sold to investment dealers and financial institutions throughout the country containing performance charts on about 193 mutual funds and pertinent information on a total of 491 mutual funds. (R. 39-44).

The Court must wonder why the Commissioner, with access to all of the knowledge and experience of the Securities and Exchange Commission, its official studies and reports and its personnel so highly qualified to testify about investment companies and the value of mutual fund shares, has studiously avoided giving the Court the benefit of its expertise in this field. The reason is that his sister agency would tell him he is completely wrong in thinking that the load is anything but an element of cost,[3] adding nothing to the value of the shares.

F. The Commissioner's long-standing interpretation of the statute should be deemed to have congressional approval and the effect of law.

For a period of at least 21 years (1941-1961) the Internal Revenue Service accepted the net asset value or redemption price as the "value" of mutual fund shares for estate tax purposes. (R. 8-12). The Commissioner's own

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[3] The latest SEC study contains such statements as "no-load shares and load shares are substitutes for each other. The only difference between them is that an investment in one entails the payment of a sales charge, which goes not to the fund itself but to the organization that does the selling." "The charge is divided among the principal underwriter, the retail dealer and the salesman who actually makes the sale." "The sales load is purely a payment for sales effort." "Section 22 (d) of the Investment Company Act of 1940 permits mutual fund managers to fix the prices at which fund shares are sold to the public and requires that all retail dealers adhere rigidly to such prices. The wisdom of this 32-year old resale price maintenance provision has been hotly debated. Many think that it simply raises investors costs without conferring any compensating benefits on them or on the public interest. Others maintain that resale price maintenance is so basic to the mutual fund distribution process that its removal would have a devasting impact on the investment company industry, the capital markets, and perhaps on the economy as a whole." Report of the Staff of the SEC "On the Potential Economic Impact of a Repeal of Section 22 (d) of the Investment Company Act of 1940" published in CCH, Federal Securities Law Reports, No. 450, Part II, dated November 15, 1972. (Quotations from page 1 of transmittal letter of Chairman William J. Casey and pages A-3 and A-93 of the Report).

prior and long-standing construction of the statute is persuasive evidence that this was the correct interpretation of their value. *Hanover Bank v. Commissioner*, 369 U. S. 672, 686 (1962).

The regulation published on October 9, 1963, is not a contemporaneous construction of the estate tax statute which has been in effect for upwards of 40 years. It was issued 23 years after the Investment Companies Act of 1940. The estate tax sections of the Code have been the subject of numerous major and minor revisions during the intervening years when the Commissioner was interpreting the statute as imposing a tax on the redemption value. He requested no legislation to authorize him to value them at replacement cost and received no Congressional rebuke as to his administration of the estate tax laws in this regard.

"This case comes within the settled principle that 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially re-enacted statutes, are deemed to have received Congressional approval and have the effect of law'". *United States v. Correll*, 389 U. S. 299, 305-306 (1967).

POINT II

The regulation was a deliberately planned effort to circumvent the position of the Department of Justice. It was added to Reg. Sec. 20.2031-8 for strategic and ulterior purposes.

A. The regulation was issued because the Department of Justice was instructing the IRS to refund estate taxes collected on the "asked" price and to substitute a new issue (whether the regulation was completely unreasonable instead of what is the fair market value) which the Commissioner could argue in the Tax Court without having to be represented by the Department of Justice.

The history of the mutual fund issue as it appears in the Statement of Facts (pp. 2-4) is based upon "Admissions Requested by Plaintiff and Revised by Defendant in his Answer to the Request" (R. 10-14) and letters from the Department of Justice ordering refunds of taxes collected by the Internal Revenue Service (R. 15-21).

In substance the Commissioner was being frustrated by the Department of Justice. He was stymied unless he could use his own legal staff to argue his position in the Tax Court. His position was weak on the question of value. But, a formal regulation would be viewed with considerable respect. Taxpayers would have the burden of proving him unreasonable, arbitrary and capricious by overwhelming evidence.

The Commissioner's confidence in this strategy was not wholly unfounded. He used the *Francis Foster Wells* case, the first case on the Tax Court docket involving a mutual fund owner dying after October 11, 1963, to test his theory. All but six of the judges of the Tax Court, in *Francis Foster Wells v. Commissioner*, 50 TC 871, accepted the proposition

that the sole issue before them was whether or not the Commissioner had been completely unreasonable, arbitrary and capricious and held that the taxpayer had failed in his burden of proof. Six of them disagreed, concurring in the brilliantly expressed and perceptive dissent of Judge Tannenwald. But the regulation had jumped its first hurdle.

The Department of Justice is obliged by statute to represent the Commissioner in the Federal Courts. It thus became obliged to defend a theory of valuation it had previously opposed. It succeeded in persuading the Sixth Circuit of Appeals to affirm the Wells case in *Ruehlmann v. Commissioner*, 418 F. 2d 1302 (1969), the rationale of which was copied by the Seventh Circuit Court of Appeals in a gift tax case, *Howell v. United States*, 414 F. 2d 45 (1969).

Respondent contends that it is quite relevant for the Supreme Court to know that the regulation was not the product of a considered judgment; that it was an arbitrary expedient to put the entire weight of the government on the taxpayer—to multiply his burden of proof and to halve his chance of getting judicial relief—with full knowledge that millions of taxpayers would have to "knuckle under" because they could not afford to litigate the reasonable versus unreasonableness issue on which the judicial presumption is weighted heavily against them.

B. The Commissioner amended the "Valuation of Certain Life Insurance Annuity Contracts" regulations instead of the securities regulations for strategic reasons.

The Commissioner mapped his strategy with unusual care. The obvious regulation to be amended was Reg. Sec. 20.2031-2—"Valuation of Stocks and Bonds". But, if the new regulation was added there it would have stuck out like a sore thumb by way of contrast with the long established methods of valuing securities at their value to the estate.

However illogical, the strategic answer was to insert the mutual fund replacement theory in Reg. Sec. 20.2031-8 entitled "Valuation of Certain Life Insurance and Annuity Contracts" which already contained a suggestion of the replacement cost theory.

It is the taxpayer's contention that the Commissioner snuggled the mutual fund regulation as close as he could to the replacement cost theory used in the valuation of single premium life insurance policies on the life of another for the specific purpose of making it more difficult for the taxpayer to show that his action was wholly unreasonable, arbitrary and capricious or completely without precedent.

Simple proof of this duplicity is found in the estate tax return (Form 706) in which the mutual fund regulation is included in the instructions governing the reporting of stocks and other securities in Schedule B. It has never been mentioned in the instructions for Schedule D (Insurance). It has no rational connection with single premium life insurance policies or annuities, but that was the only way the Commissioner could claim it was somewhere in the orbit of his distorted version of *Guggenheim v. Rasquin*, 312 U.S. 254.

C. The mutual fund regulations are only part of a larger scheme to substitute the replacement cost theory for long accepted concepts of valuation of assets comprising an estate.

Treasury Decision 6680, valuing mutual funds at the replacement cost, seems to have been the opening wedge in the Treasury's attempt to legislate a new criterion for the valuation of property subject to estate tax, *i.e.* to substitute replacement cost for value. Its next move was another startling departure from the theory of valuation that had

prevailed during the preceding 30 to 40 years period. On June 7, 1965, it amended Reg. Sec. 20.2031-1 (b) entitled "Valuation of Property in General" by inserting three sentences (T. D. 6826, 1965-2 C. B. 367), as follows:

> "Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus in the case of an item of property includable in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such item of property is the price at which the item or a comparable item would be sold at retail. For example, the fair market value of an automobile (an article generally obtained by the public in the retail market) includable in the decedent's gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc. could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles. Examples of items of property which are generally sold to the public at retail may be found in §§ 20.2031-6 and 20.2031-8."

The significance of this amendment should be apparent from the simple illustration which follows.

At the time of his death Mr. A owns a 1968 Buick Electra. If his widow wanted to, she could sell it to the local dealer for $2,400.00. She decides to keep it. At about the same time, Mr. B sells his 1968 Buick Electra to the dealer for $2,400.00.

The dealer invests another $400.00 to clean the motor and upholstery, install new tires, do the necessary body work, fix the radio and otherwise recondition the car for sale on his lot for $3,000.00, hoping to get enough to pay his salesman's commission and make a profit.

If Mrs. A had sold the car for $2,400 instead of keeping it, the Commissioner would agree that the actual selling price was the best evidence of its value for estate tax purposes. Rev. Rul. 70-512, 1970-2 C. B. 192. The $2,400 which Mr. B got for his Buick is equally persuasive evidence that her car was worth $2,400 at the time.

But, the Commissioner says that the fair market value of Mrs. A's car is $3,000, because that is what Mrs. A would have had to pay to purchase Mr. B's car from the dealer.

The Commissioner has to know he is wrong. The $600 difference was used by the dealer to pay for parts, the wages of his mechanics, the commission to his salesman and for overhead in his dealership. It is incomprehensible that the $600 could possibly be an *element of value* to Mrs. A. It is part of the *cost* of acquisition of the buyer of a reconditioned Buick Electra and nothing more. But the extra tax revenues on a few hundred thousands of automobiles a year is tempting.

The editor of the section on "Valuation of Property" for the Research Institute of America says much the same thing in a Tax Coordinator (Volume 6, paragraph P-6002.2) in which he describes the Treasury's "retail" valuation rules. He says:

> "But in '65 the Treasury changed the meaning of this basic rule for valuing property which is generally obtained by the public in the retail market so that the hypothetical seller is not the taxpayer, but rather some commercial seller . . . Under this rule the gift tax value of Mr. Smith's Cadillac, above, is not the $3,400 for which he could sell it, but rather the higher price a used car dealer would get for it, say $4,000."

The editor also noted the effort that the Treasury Department was making to extend the replacement cost theory

on a wide scale to other property by incorporating his new theory in various private rulings in regulation form.

This "retail market" theory of valuation of automobiles and household and personal effects has been in the regulations for nearly six years. It is not being enforced in the field; if it ever is, there will be a flood of petitions to the Tax Court and refund claims in the District Courts because the idea is completely unacceptable.

Undoubtedly, the Internal Revenue Service is reluctant to test this theory with an automobile until it has finally nailed down the replacement cost theory in the mutual fund cases. An adverse decision would put the mutual fund issue in too clear a perspective.

Just as in the case of mutual funds, there are two markets, so to speak, for automobiles. The first is the retail market or retail price at which the manufacturer, through its enfranchised retail sales organization, sells new cars. The second, the "trade in" or "used" car market, is the only market or price available to the owner of a used automobile; not even the retail price of a used car, just the "as is" price he can get for it in the open market. It is completely incongruous for the Commissioner to value a decedent's used belongings and secondhand property at "retail".

The regulation can only be interpreted as a bold attempt by the Commissioner to (1) change the traditional willing buyer-willing seller test to a willing buyer-willing "retail dealer" concept and (2) redefine value in terms of replacement cost, both of which are beyond his province and solely within the legislative jurisdiction of the Congress.

None of these regulations were "needful" after upwards of 40 years of undisputed acceptance of the Commissioner's

method of determining the value of automobiles, boats, pianos, silverware, jewelry, etc. for estate tax purposes under Reg. Sec. 20.2031-6 and over 20 years of non-controversial valuation of mutual funds under Reg. Sec. 20.2031-2.

The Commissioner's new regulations are clearly intended to legislate the method which would produce the greatest revenue without regard to well-established concepts of fair market value.

POINT III

The regulation is inconsistent with § 2031 and § 2033 of the Internal Revenue Code.

§ 2031 is specific that it is the "value" of all property forming "the gross estate of the decedent" that shall be determined; not the "cost" of property bought by another.

§ 2033 provides:

> "The value of the gross estate shall include the value of all property *to the extent of the interest therein of the decedent* at the time of his death." (Emphasis supplied)

The Ninth Circuit Court of Appeals, in *Robert C. Davis v. United States*, 460 F. 2d 769, decided May 23, 1972, said:

> "By no stretch of the imagination does the decedent have an interest in the $.37 per share difference representing the sales load. He cannot make a transfer so that his transferee may realize this amount; he cannot realize it himself either as a part of his own certificate or separated from it. The sales load is similar to a broker's commission charged on the purchase of stocks listed on a stock exchange. Under Treasury Regulation § 20.2031-2(b) the sales charge is not part of the gross estate."
>
> . . . .

"To apply the estate tax rate to the sales charge paid is to impose a tax on a non-existent 'interest of a decedent'. The regulation which permits it, Treasury Regulation § 20.2031-8 (b), is inconsistent with the Internal Revenue Code of 1954, as amended, and specifically with 26 USC § 2033."

The statute says "value"; not "cost". They are not synonymous. Cost of comparable contracts, replacement cost, retail price, etc. are only some evidence of value. In some case, like a share of General Motors, replacement cost exceeds value by the amount of the broker's commission. In the case of a mutual fund share it exceeds value by 8%.

In the case of a deceased lawyer's library, replacement cost could exceed its value in the estate by 300% ($15,000.00 versus $5,000.00). In the case of a decedent's stately old mansion on a once fashionable street now the victim of urban blight, replacement cost may exceed its current value by 1,000% ($300,000.00 versus $30,000.00).

By substituting the replacement cost or retail price of property bought by someone else for the value of the interest of a decedent in his own property, the Commissioner has created a rule completely out of harmony with the statute.

". . . Regulations 'are not absolute rules of law' and should not be followed when they are in conflict with the 'design' of the applicable section of the Code." *Dorfman v. Commissioner,* 394 F. 2d 651 (CCA-2, 1968). The Commissioner's authority "does not extend to the establishment of rules of substantive law creating presumptions of fact which are out of harmony with the statute involved." *Commissioner v. Produce Reporter Co.,* 207 F. 2d 586, 587 (CCA-7, 1953). "Where a regulation is an amendment or a modification of a statute and therefore beyond the power of the Commissioner to make . . ." It will not

be sustained. *Gamman v. Commissioner*, 46 TC 1, 8 (1966). Interpretative regulations of the Commissioner which are arbitrary and discriminatory are void. *Royers v. U. S.*, 265 F. 2d 615 (CCA-3, 1959); *Willett v. Commissioner*, 365 F. 2d 760 (CCA-5, 1966).

The following quotation from the decision of this Court in *Manhattan General Equipment Company v. Commissioner*, 297 U. S. 129, 134, is appropriate:

> "The power of an administrative officer or board to administer a federal statute and to proscribe rules and regulations to that end is not the power to make law —for no such power can be delegated by Congress— but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity."

POINT IV

The regulation is unconstitutional under the holding in Heiner v. Donnan, 285 U. S. 312.

A. It creates a conclusive presumption of fact as to value which the taxpayer is forbidden to controvert and which precludes consideration of "all relevant facts" in violation of due process under the Fifth and Fourteenth Amendments.

The regulation is inherently arbitrary in its attempt to usurp the power of the judiciary to make a determination based on "all relevant facts and elements of value . . . in every case". Reg. Sec. 20.2031-1(b).

Even if the executor had sold all of the shares as of the date of the decedent's death for their net asset value (thereby providing the Court with the best evidence of their value as of that date) the regulation would still arbitrarily value them at replacement cost. It purports

to create a conclusive presumption as to the correct "value" for estate tax purposes. It lacks due process because it imposes a "value" which is inherently arbitrary and was designed to deprive the taxpayer of the right to submit contrary proof or other evidence bearing on "value".

This Court, in *Heiner v. Donnan*, 285 U. S. 312 (1932), held that even Congress could not create a conclusive presumption in the Tax Law, saying:

> "There is no doubt of the power of Congress . . . . to create a rebuttable presumption that gifts made within a period of two years prior to death are made in contemplation thereof. But the presumption here created is not of that kind. It is made definitely conclusive—incapable of being overcome by proof of the most positive character. Thus stated, the first question submitted (Does the second sentence of §302 (c) of the Revenue Act of 1926 violate the due process clause of the Fifth Amendment to the Constitution of the United States?) is answered in the affirmative by Schlesinger v. Wisconsin, 270 U. S. 230 . . . . and Hoeper v. Tax Commission, 284 U. S. 206 . . . ." . . . . .

> "The Schlesinger case has since been applied many times by the lower Federal Courts, by the Board of Tax Appeals, and by state courts and none of them seemed to have been at any loss to understand the basis of the decision, namely, that a statute which imposed the tax upon an assumption of fact which the taxpayer is forbidden to controvert, is so arbitrary and unreasonable that it cannot stand under the Fourteenth Amendment.". . . . .

> "Nor is it material that the Fourteenth Amendment was involved in the Schlesinger case, instead of the Fifth Amendment, as here. The restraint imposed upon legislation by the due process clauses of the two amendments is the same."

The holding in *Heiner v. Donnan* has had great vitality in the fields of both statutory and adminstrative law. Some of the cases in which the courts have seen fit to assert the

constitutional right of the citizen to judicial relief from arbitrarily conclusive administrative determinations include: *Reinecke v. Smith*, 61 F. 2d 324 (CCA-7, 1932); *Commissioner v. Shattuck*, 97 F. 2d 790 (CCA-7, 1938); *Commissioner v. Clark*, 202 F. 2d 24 (CCA-7, 1953); *Mourning v. Family Publication Services, Inc.*, 449 F. 2d 235 (CCA-5, 1971); *Carrington v. Rash*, 380 U. S. 89; *Dunn v. Blumstein*, ——U. S. ——, 31 L. Ed. 2d, 274 (1972).

This case is solidly within the rule of *Heiner v. Donnan.* The trial judge found, as a fact, on the basis of uncontroverted evidence that the value of Mrs. Bennett's mutual fund shares was $124,399.87; not $133,325.14. Judge Hauk, in *Robert C. Davis v. United States*, 306 F. Supp. 949, made a factual finding on the evidence that the value of the mutual funds in the Davis Estate was their net asset value. A similar finding was made by the trial court judge in *Hicks v. United States*, 335 F. Supp. 474.

The Commissioner's position necessarily is that even if every trial court in the United States were to make a similar finding of fact, his regulation is irrebuttable, conclusive and binding both on the taxpayers and on the courts.

This taxpayer is confident that this Court will not countenance such a bold denial of due process of law.

POINT V

Reply to appellant's brief.

The government's brief does about all that can be done in support of the Commissioner's new theory. It paraphrases the arguments used by the Tax Court in *Frances Foster Wells v. Commissioner*, 50 TC 871, in the decision which affirmed that case, *Ruehlmann v. United States*, 418 F. 2d 1302 and *Howell v. United States*, 414 F. 2d 45, in

such a way as to make them appear to give at least some support to the claim that the Commissioner was not completely unreasonable in issuing the regulation.[4]

In addition to the arguments extracted from the cases cited above, the government's brief contains a few peripheral arguments for which no authorities are cited. These are based upon assumed facts of which no proof was offered at the trial and for which there is no support in the record.

These arguments, all of which are necessarily theoretical, hypothetical and legalistic are described below in separate subheadings with appropriate discussions as to each.

A. The "reasonable alternatives" argument (Br. p. 9).

This is not an "area of limitless factual situations" as existed in *United States v. Correll*, 389 U.S. 299 (when is a taxpayer away from home?) or *Bingler v. Johnson*, 394 U. S. 741 (what is a fellowship or scholarship?), where the Commissioner had a choice of many definitions, a number of which were equally reasonable, though not necessarily perfect, definitions.

Here there are only two possible answers, one of which is right and reasonable, the other wrong and unreasonable.

This Court faced similar questions in such cases as *Eisner v. Macomber*, 252 U. S. 189 (does a stockholder realize taxable income from a stock dividend or doesn't he?) and *Mass v. Higgins*, 312 U. S. 443 (is the income received

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[4] None of these cases, *Wells v. Commissioner* (*supra*), *Ruehlmann v. C. I. R.* (*supra*) or *Howell v. United States supra*, looked first to the facts to determine the real value of a mutual fund share before passing on the reasonableness of the regulation. They seem to have been concerned only with the legalistic argument that the regulation must be sustained unless the taxpayer proves it to be so completely unreasonable as to be invalid.

during the year after death taxable as property belonging to the decedent when he died or isn't it?). One answer would be right, and the other wrong. The following quotation from *Mass v. Higgins* is tailormade for the facts of this case:

> "The petitioners insist that the government's position is unreal and artificial; that it does not comport either with economic theory or business practice; and that the regulation is an unwarranted extension of the plain meaning of the statute and cannot, therefore, be sustained. We hold that the petitioners are right."

A mutual fund share, like a car or any other product with a tradein or resale value, sells at two prices or in two makets, so to speak, depending upon who is selling it.

Only a registered and regulated investment company and its marketing agent or retail sales organization has access to the retail market "asked" price for its new shares. 15 U. S. C. § 80a-2, 7, 22 (d).

The only market or price to which the owner or his estate has access is the "used", so to speak, or "bid" price market. It is totally unrealistic for the Commissioner to contend that both the public offering price and the bid price are reasonable alternatives to assign to shares owned by an estate. The estate has only one choice. The Commissioner is completely unreasonable in saying he has two.

Here issue was joined in the trial court on the question as to the value to the estate within the meaning of § 2031 of the Code. The trial court's findings, based on all the facts, were that the only price available to the estate was the bid price; that the public offering price available to the issuing company was incorrect, unrealistic and unreasonable and, as a necessary corollary, that the regulation is invalid.

The Commissioner made no attempt to show that the public offering price was in any way a reasonable alternative price available to the estate, placing sole reliance on his regulation. Lacking any support in the record, the Commissioner should be precluded by his own failure of proof from now contending that there are two reasonable alternatives from which he may make a choice in his discretion.

B. The "Guggenheim case" argument (Br. p. 12-13).

It was predictable from the insertion of the mutual fund regulation in the "single premium life insurance on the life of another" regulation that the Commissioner was trying to get more mileage out of the *Guggenheim* case in terms of estate taxes, even though it was a gift tax case.

The decisions in the lower courts have effectively disposed of this argument and there is no need to summarize what the Court will read in any event.

It might be helpful, though, if the writer could demonstrate, by a simple analogy, the extent to which the Commissioner has, by regulation, tortured the reasoning in the *Guggenheim* case for estate tax purposes.

A thoughtful husband purchases a Buick Electra for his wife in 1965 at a cost of $6,000.00. There is no question that he made a $6,000.00 gift; just as surely as if he had given her $6,000.00 to go buy it for herself. He would be wrong, just as Mrs. Guggenheim's tax adviser was wrong, in claiming that the amount of the gift was the $5,400.00 the car was worth once she drove it to the store.

If his check to the dealer had been for $6,300.00 to include a 5% sales tax, the amount of the gift would have been $6,300.00; just as surely as if he had given her $6,000.00 to pay for the car and $300.00 to pay the sales tax. So, the people who prepared the gift tax returns for Mr. Gould

(*Gould v. Commissioner*, 14 TC 414), Mrs. Publicker (*Publicker v. Commissioner*, 206 F. 2d 250) and Mr. Duke (*Duke v. Commissioner*, 200 F. 2d 82) were equally in error in arguing that the amount of the gift did not include the luxury wartime excise tax.

But, suppose our thoughtful husband bought the car for himself in 1965 and drove it the seven years prior to his death in 1972. By then it would be properly valued as a $400.00 piece of junk.

Yet, if the car were to be valued in his estate under the "cost of comparable contracts at the attained age of the insured" formula of Reg. Sec. 20.2031-2 (h), *i.e.* as the price of a brand-new single premium life insurance policy on the life of another is held to be the value of the policy owned by the estate, it would be taxed in the gross estate at the $7,200.00 price tag of a 1972 Buick Electra.

The Commissioner claims this was what the Supreme Court meant by its decision in the *Guggenheim* case. It quite surely did not.

The fact of the matter was that the Commissioner issued the Estate Tax regulation to use the "reasonable versus unreasonable" argument to confuse the issues in the *Estate of Richard DuPont* just as he did in the *Wells* case (*supra*).

Richard DuPont's Estate included five single premium life insurance policies on his father's life and an interest in a trust owning 17 additional policies. Just as in the *Wells* case, the executor argued that the cash surrender value was all they were worth to the Estate. The Tax Court sided with the Commissioner. *Estate of Richard C. DuPont v. C.I.R.*, 18 TC 1134.

The executor might still have had a fighting chance in the Third Circuit Court of Appeals, but, just as in this case,

the Commissioner used his power to issue regulations to make the DuPont Estate jump one more hurdle. He amended the Estate Tax Regulations to specify that "the value (in an estate) of . . . an insurance policy on the life of a person other than the decedent, issued by a company regularly engaged in the selling of contracts of that character is established through the sale by that company of comparable contracts". This regulation was issued on May 27, 1952, while the Tax Court was still deliberating its decision. T. D. 5906, 1952-1 C. B. 155.

To remove any doubt that the new rule applied to DuPont's Estate, it was made retroactive to estates of decedents dying before January 1, 1952 (Subparagraph (j), page 158).

Therefore, the principal question considered by the Third Circuit Court of Appeals was the "reasonableness versus the unreasonableness" of the Commissioner's regulation. *DuPont's Estate v. Commissioner*, 233 F. 2d 210 (1956), certiorari denied 352 U. S. 878.

Though the Court recognized in its opinion that the actual value, as a practical matter, might be more or less than the cash surrender value, depending upon the age and state of health of the insured, thus recognizing the existence of other relevant factors, it nevertheless held for the government on the premises that the Commissioner had not been completely unreasonable in issuing the regulation.

Having successfully used the *Guggenheim* case to win the *DuPont* case, the Commissioner decided to use the same technique in an effort to win the mutual fund issue.[8]

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[8] This is not an isolated illustration of the use of "quasi-legislation by regulation" as a bulldozer to clear the path for the Commissioner. Many Courts have had occasion to be critical of his arbitrary use of

(Footnote continued on following page)

C. The "entire bundle of rights" argument (Br. p. 16).

The Government's brief also cleverly paraphrases the "Bundle of Rights" language of the Guggenheim case in an effort to subtly identify mutual funds shares with single premium life insurance policies and, by inference, with his replacement cost theory.

The inference is that the public offering price somehow represents a special value that investors attach to mutual funds shares that they do not attach to their other stock investments.

The Securities & Exchange Commission reported exactly the opposite to Congress:

> "For most investors the sales charges for buying mutual fund shares are considerably higher than charges for buying and selling other types of securities. These higher costs do not pay for and are altogether unrelated to either the professional investment management or the portfolio diversification that the funds supply. No-load funds and closed-end investment companies furnish the same professionally managed, diversified portfolio as load funds do; yet no-load fund shares are available without the sales charges that investors pay when they buy load fund shares, and the sales charges on closed-end shares are those generally applicable to transactions in listed or

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(Footnote continued from preceding page)
self-serving determinations to shape or change the law instead of interpreting it.

Cumulative evidence of this may be found in *Kurzner v. U. S.*, 413 F. 2d 97 (CCA-5, 1969); *Gamman v. C. I. R.*, 46 T. C. 1 (1966); *Stennett v. C. I. R.*, 54 T. C. 221 (1970), *Amory Cotton Oil Co. v. U. S.*, and *Shores Realty Co., Inc. v. U. S.*, 72-2 USTC 9714 and 9715 (CCA-5, 1972); *Commissioner v. Shattuck*, 97 F. 2d 790 (CCA-7, 1938), *Commissioner v. Clark*, 202 F. 2d 94 (CCA-7, 1953); *United States v. Empey*, 406 F. 2d 157 (CCA-10, 1969); *LaForge v. C. I. R.*, 434 F. 2d 370 (CCA-2, 1970). For a tax practitioner's viewpoint see, for example, "A Critical View of the Treasury" in NYU Annual Institute on Federal Taxation, Vol. 15, pages 21-40.

over-the-counter securities. Managerial expertise and portfolio diversification are paid for by other charges which are of a continuing nature—an annual advisory fee and brokerage commissions. The sales load—paid at the time of purchase—is purely a payment for selling effort."

> *S. E. C. Report on the Public Policy Implications of Investment Company Growth*, House Report No. 2337, 89th Cong., 2d Sess. 214-215 (1966).

Justice Tannenwald's dissenting opinion in *Frances Foster Wells v. Commissioner*, 50 TC 871, 879, correctly analyzes the bundle of rights argument:

> "The emphasis by the majority on the fact that the estate and the beneficiaries may continue to own the mutual fund shares and thereby enjoy the benefits of ownership is, in my opinion, wholly misplaced. These possibilities exist with respect to every type of security. If the majority standard is correct, it would be no less 'appropriate' to use replacement cost with respect to marketable securities of all kinds. This, however is simply not the law."

D. The "no hardship" argument (Br. pp. 17-18).

The Tax Court used an irrelevant argument in *Wells v. Commissioner*, 50 TC 871, 877, saying that, after all, the estate or the heirs might be able to get part of the estate tax back as an administration expense or on a subsequent sale. The government's brief uses this same apology, citing Reg. Sec. 20.2053-3(d)(2).

The reference is to the capital loss the executor would realize if he sold instead of distributing the shares in kind and the capital loss the heirs would realize if they later sold them for their own account.

What both omitted to explain is that:

1. A deduction of this capital loss as an expense of administration is allowed only if the sale was *necessary to pay debts*, etc. Reg. Sec. 20.2053-3. This condition is also noted in the Tax Coordinator published by Research Institute of America in paragraph R-6016.5 on page 46,118A as follows:

> "If property is in fact sold or redeemed to a *dealer* for less than its fair market value, then the 'loss' (value over price paid by dealer) is deductible *as an administration expense.* The net practical effect is to wash out the higher fair market value included in the gross estate by an offsetting deduction *if* sold to a dealer. But for this rule to apply, the sale must be necessary in order to pay the decedent's debts and expenses of administration or taxes, to preserve the estate or effect distribution." (Emphasis supplied)

If Mrs. Bennett's executor had sold them, he could not have claimed the loss because the sale would not have been *necessary* under the regulations.

2. The Commissioner's amendment to Reg. Sec. 20.2053-3 by TD 6826, 1965-2 CB 367, is wholly illegal and invalid and completely outside the scope of his authority. The loss on the sale of a mutual fund share, like the loss on the sale of any other stock, is a capital loss. The loss on the sale of a private automobile is a non-deductible capital loss. § 2054 of the Code limits the deduction of losses to fires, storms, shipwrecks and other casualties. The Commissioner has no right to add additional classes of losses to § 2054. He has even less right to disguise them as administration expenses and allow them under § 2053. The amendment is clearly invalid.

The "higher basis for capital gain or loss purposes" argument is subject to the same criticism. It is valueless to beneficiaries who elect to keep their shares subject to another estate tax at the same fictitious value. Furthermore, only one-half of the "load" would be taken into account in determining the capital gain or loss resulting from a subsequent sale, if any were sold (Form 1040, Schedule D).

Judge Curtin was right when he said " . . . If the regulation setting fair market value is unreasonable, this unreasonableness cannot be cured by a regulation which limits the hardship imposed upon a taxpayer." 323 F. Supp. 769.

He might well have added that TD 6826, 1965-2 CB 367 is only further proof of the violence the Commissioner is doing to the statutes he is supposed only to interpret, because of his recent plunge for the replacement cost theory of valuation.

E. The "price the public pays in the retail market" argument (Br. p. 11).

The government's brief calls the Court's attention to Reg. Sec. 20.2031-1(b) as though the three sentences added to the regulation by T. D. 6826, 1965-2 CB 367 (quoted on page 31) were precedent for the mutual fund regulation when, in fact, they were not added to the general valuation section for more than a year and a half after the mutual fund regulation was issued.

The Commissioner is not being completely candid. The cross reference to mutual fund shares and single premium life insurance policies on the life of another in the last sentence (the reference to Reg. Sec. 20.2031-8) was to lay the foundation for a claim that he was not completely without precedent in valuing automobiles and household furniture

at "replacement cost" or "retail". Now, turning it around, he claims it shows he was not without precedent for valuing mutual fund shares at replacement cost.

The Court is respectfully referred to Point II, C (*supra*) for the respondent's discussion of this clearcut misinterpretation of the statute.

F. The "new underwriting" argument (Footnote, Br. p. 11).

The attempted analogy between a new underwriting in which the issuer does not guarantee to repurchase the shares at any price and the sale of mutual fund shares with a guaranteed redemption price is superficial. Perhaps that is why it has been relegated to a footnote. It ignores two important differences.

1. The subscriber to a share of a new underwriting, say, at the $100 offering price can sell it the same day at $100, perhaps more, because the "fair market value is determined by the law of supply and demand after the issuance" (R. 66-68). But, the purchaser of a share of a mutual fund for, say, $108 can sell it the same day *only* for its redemption price of $100. If Mr. Cartwright had purchased as many additional shares as the decedent owned for $133,325 on the day of her death, they too would have been worth only their redemption value of $124,399.

2. We are not concerned here with the value as of the date of purchase. Instead we are concerned with the value, as of the date of Mrs. Bennett's death, of shares which had been purchased by her deceased husband many years before. The original cost to him becomes a matter of historical unimportance and the commission he paid had long since ceased to be a "component element of value", if it ever was.

G. The "new legislation" argument (Footnote, Br. p. 22).

The legislation pending before Congress reflects unfavorably on the Commissioner's action.

A more reasonable interpretation of the situation is that it reflects some consensus of opinion that the regulation is basically unfair and unreasonable; it is some evidence that the Commissioner has again abused his regulatory powers and has in fact legislated in this area; so that Congressional legislation is necessary to undo or "repeal" Reg. Sec. 20.2031-8(b).

H. The Ruehlman and Howell cases.

Judge Hauk, in *Robert C. Davis v. United States*, 306 F. Supp. 949, affirmed 460 F. 2d 769 (CCA-9, 1972) characterized the reasoning in the *Ruehlmann* and *Howell* cases as "logical infirmities and unrealistic conclusions serving only to strengthen his conviction that the only true actual realistic value was the redemption price."

Interestingly enough, the government seems to have abandoned the major reasons given by the Tax Court and the Sixth and Seventh Circuit Courts of Appeal for refusing to find the regulation completely unreasonable.

Even though the government does not stress these arguments, the Court might appreciate a brief commentary on them as follows:

The "different breed of cats" argument.

Any contention by the Commissioner that mutual fund shares are "kissin' kin" of insurance policies would have to be suspect when:

1. The Internal Revenue Service requires executors to report them in federal estate tax returns (Form 706) in Schedule B entitled "Stocks and Bonds".

2. The mutual fund regulation appears among the instructions for reporting "Stocks and Bonds" in Schedule B and has never been included in Schedule D (Insurance) (Form 706).

3. The Internal Revenue Service requires taxpayers to report the dividends and capital gains distributions from mutual fund shares in Schedule B, Part I, entitled "Gross Dividends and Other Distributions on Stock" (Form 1040 and the instruction booklet).

4. Congress assigned the jurisdiction over regulated investment companies to the Securities and Exchange Commission, etc., etc., etc.

The "bid price is not a willing buyer-willing seller price" argument.

The Seventh Circuit in *Howell v. United States* (supra) was under the misapprehension that the investment company sold them at the asked price and redeemed them at the bid price and that it was thus "impossible to match a willing buyer and a willing seller". If it were impossible for buyers and sellers to agree on a price, one would rightfully wonder how any sales were ever made. So, it is quite understandable why the petitioner has abandoned this line of reasoning.

The "required by law" argument.

It also noted the "required by law" argument used by the Sixth Circuit Court of Appeals in the *Ruehlmann* case; that the investment company was not a willing purchaser at the redemption price.

Because this is incorrect, positive evidence was developed in this case that each of the three Investors Companies

voluntarily elected to be open-end investment companies with redeemable shares; that this election was made in their certificates of incorporation prior to registration with the SEC (R. 76-77); that they had to be incorporated before registering with the SEC (15 USC § 80A-8) and that these Investors Companies consider it advantageous for sound and realistic business reasons to willingly offer and to stand ready, willing and able at all times to redeem any shares presented to them. The promise of immediate and guaranteed liquidity is an extremely important and integral part of making a sale (R. 49-52). They compete effectively with securities on the exchanges by promising to redeem shares "upon receipt of the certificates and pay for them within seven business days" (R. 52).

In the face of such clear-cut documentary evidence and expert testimony in the record of this case, the petitioner has quite correctly abandoned this argument too.

I. Fallacies in petitioner's brief.

The petitioner uses a number of devious and subliminal techniques in an effort to portray a horse chestnut as a chestnut horse including clever phrasing to disguise non-sequiturs and make contradictions appear compatible, supporting one faulty argument with another and stating, as accepted or proven facts, those which have been disproven. For example, in the Orwellian view of the petitioner:

1. The mutual fund regulation must be sound because he has already decided under his automobile regulation, Reg. Sec. 20.2031-1(b)—which he has has been afraid to enforce—that his widow should have to pay the estate tax on $4,200.00 even though she can get only $3,400.00 for his secondhand Cadillac (Br. p. 11).

2. It would be wrong, when shares are subject to a contract or option to purchase, to value them at price higher than the contract or option price. Therefore, mutual funds should be valued at more than the estate can get for them (Br. pp. 20-21).

3. It is an advantage for the estate to "incur the hardship" of paying estate taxes on the load so it can get an "administrative expense deduction" useable only if it is absolutely necessary to sell the shares to pay debts, taxes or effect distribution (Br. pp. 6-7).

4. There is really an advantage to be gained by paying the 100% estate tax on the load so that the beneficiary can "enjoy the benefit" of the 50% income tax deduction at the capital gains rate (Br. pp. 6-7).

5. Sales at the public offering price are the "only market in which shares are commonly sold" (Br. pp. 10-11) (yet, in Footnote 4, page 3, informs the Court that "sales back" to the companies at the bid price aggregate many millions of shares each year. It is also a known fact that during a substantial part of 1972 "sales back" exceeded "sales by" by many millions of shares with a substantial adverse impact on the industry).

Conclusion

For over 22 years mutual fund shares were valued in the same manner as other securities. The Commissioner now seeks to upset this long-settled rule by means of a regulation so totally at variance with existing methods of valuing securities that he is ashamed to put it in the same section with them. This regulation would tax mutual funds at a value which the estate could never realize under any circumstances.

This is a flagrant example of bureaucratic legislation which recalls the words of Mr. Justice Douglas in *Commissioner v. Lester*, 366 U. S. 312:

> "Resort to litigation rather than to Congress, for a change in the law, is too often the temptation of government which has a longer purse and more endurance than any taxpayer."

The decision of the Court below should be affirmed.

Respectfully submitted,

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